

## § 1.402(b)-1

## 26 CFR Ch. I (4-1-03 Edition)

§ 1.403(b)-1(d)(4) as the end of such taxable year, over

(ii) The amount determined in accordance with the formula described in § 1.403(b)-1(d)(4) as of the end of the prior taxable year,

or the amount determined under any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan.

(b) *Taxability of employee when rights under nonexempt trust change from non-vested to vested*—(1) *In general.* If rights of an employee under a trust become substantially vested during a taxable year of the employee (ending after August 1, 1969), and a taxable year of the trust for which it is not exempt under section 501(a) ends with or within such year, the value of the employee's interest in the trust on the date of such change shall be included in his gross income for such taxable year, to the extent provided in paragraph (b)(3) of this section. When an employees' trust that was exempt under section 501(a) ceases to be so exempt, an employee shall include in his gross income only amounts contributed to the trust during a taxable year of the employer that ends within or with a taxable year of the trust in which it is not so exempt (to the same extent as if the trust had not been so exempt in all prior taxable years).

(2) *Value of an employee's interest in a trust.* (i) For purposes of this section, the term "the value of an employee's interest in a trust" means the amount of the employee's beneficial interest in the net fair market value of all the assets in the trust as of any date on which some or all of the employee's interest in the trust becomes substantially vested. The net fair market value of all the assets in the trust is the total amount of the fair market values (determined without regard to any lapse restriction, as defined in § 1.83-3(h)) of all the assets in the trust, less the amount of all the liabilities (including taxes) to which such assets are subject or which the trust has assumed (other than the rights of any employee in such assets), as of the date on which some or all of the employee's

interest in the trust becomes substantially vested.

(ii) If a separate account in a trust for the benefit of two or more employees is not maintained for each employee, the value of an employee's interest in such trust shall be determined in accordance with the formula described in § 403(b)-1(d)(4) or any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which the contributions are made and the method adopted by the employer for funding the benefits under the plan.

(iii) If there is no valuation of a non-exempt trust's assets on the date of the change referred to in paragraph (b)(1) of this section, the value of an employee's interest in such trust is determined by taking the weighted average of the values on the nearest valuation dates occurring before and after the date of such change. The average is to be determined in the manner described in § 20.2031-2(b)(1).

(3) *Extent to which value of an employee's interest is includible in gross income.* For purposes of paragraph (b)(1) of this section, there shall be included in the gross income of the employee for his taxable year in which his rights under the trust become substantially vested only that portion of the value of his interest in the trust that is attributable to contributions made by the employer after August 1, 1969. However, the preceding sentence shall not apply—

(i) To the extent such value is attributable to a contribution made on the date of such change, and

(ii) To the extent such value is attributable to contributions described in paragraph (d)(1) (ii) or (iii) of this section (relating to contributions made pursuant to a binding contract entered into before April 22, 1969).

For purposes of this (3), if the value of an employee's interest in a trust which is attributable to contributions made by the employer after August 1, 1969, is not known, it shall be deemed to be an amount which bears the same ratio to the value of the employee's interest as the contributions made by the employer after such date bear to the total contributions made by the employer.

(4) *Partial vesting.* For purposes of paragraph (b)(1) of this section, if only

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part of an employee's interest in the trust becomes substantially vested during any taxable year, then only the corresponding part of the value of the employee's interest in such trust is includible in his gross income for such year. In such a case, it is first necessary to compute, under the rules in paragraphs (b) (1) and (2) of this section, the amount that would be includible if his entire interest had changed to a substantially vested interest during such a year. The amount that is includible under this paragraph (4) is the amount determined under the preceding sentence multiplied by the percent of the employee's interest which became substantially vested during the taxable year.

(5) *Basis.* The basis of any employee's interest in a trust to which this section applies shall be increased by the amount included in his gross income under this section.

(6) *Treatment as owner of trust.* In general, a beneficiary of a trust to which this section applies may not be considered to be the owner under subpart E, part I, subchapter J, chapter I of the Code of any portion of such trust which is attributable to contributions to such trust made by the employer after August 1, 1969, or to incidental contributions made by the employee after such date. However, where contributions made by the employee are not incidental when compared to contributions made by the employer, such beneficiary shall be considered to be the owner of the portion of the trust attributable to contributions made by the employee, if the applicable requirements of such subpart E are satisfied. For purposes of this paragraph (6), contributions made by an employee are not incidental when compared to contributions made by the employer if the employee's total contributions as of any date exceed the employer's total contributions on behalf of the employee as of such date.

(7) *Example.* The provisions in this paragraph may be illustrated by the following example:

*Example.* On January 1, 1968 M corporation establishes an employees' trust, which is not exempt under section 501(a), for some of its employees, including A, reserving the right to discontinue contributions at any time. M

corporation contributes \$5,000 on A's behalf to the trust on February 1, 1968. At the time of contribution 50 percent of A's interest was substantially vested. On January 1, 1971, and January 1, 1974, M corporation makes additional \$5,000 contributions to the trust on A's behalf. A's interest in the trust changed from a 50 percent substantially vested to a 100 percent substantially vested interest in the trust on December 31, 1974. Assume that the value of A's interest in the trust on December 31, 1974, which is attributable to employer contributions made after August 1, 1969, is calculated to be \$11,000 under paragraph (b)(3) of this section. The amount includible in A's gross income for 1971 and 1974 is computed as follows:

(i) Amount of M corporation's contribution made on January 1, 1971, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times \$5,000 contribution)—\$2,500.

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(i) Amount of M corporation's contribution made on January 1, 1974, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times \$5,000 contribution)—\$2,500.

(ii) Amount which would have been includible if A's entire interest had changed to a substantially vested interest (value of employee's interest in the trust attributable to employer contributions made after August 1, 1969—\$11,000.

(iii) Percent of A's interest that became substantially vested on December 31, 1974—50 percent.

(iv) Amount includible in A's gross income for 1974 in respect of his percentage change from a substantially nonvested to a substantially vested interest in the trust (50 percent of \$11,000)—\$5,500.

(v) Total amount includible in A's gross income for 1974 ((i) plus (iv))—\$8,000.

(c) *Taxation of distributions from trust not exempt under section 501(a)*—(1) *In general.* Any amount actually distributed or made available to any distributee by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be taxable under section 72 (relating to annuities) to the distributee in the taxable year in which it is so distributed or made available. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, for example, the distribution from such a trust consists of an annuity contract,

the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution. Such value is includible in the gross income of the distributee to the extent that such value exceeds the investment in the contract, determined by applying sections 72 and 101(b). The distributions by such a trust shall be taxed as provided in section 72 whether or not the employee's rights to the contributions become substantially vested beforehand. For rules relating to the treatment of employer contributions to a nonexempt trust as part of the consideration paid by the employee, see section 72(f). For rules relating to the treatment of the limited exclusion allowable under section 101(b)(2)(D) as additional consideration paid by the employee, see the regulations under that section.

(2) *Distributions before annuity starting date.* Any amount distributed or made available to any distributee before the annuity starting date (as defined in section 72(c)(4)) by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be treated as distributed in the following order—

(i) First, from that portion of the employee's interest in the trust attributable to contributions made by the employer after August 1, 1969 (other than those referred to in paragraph (d)(1) (ii) or (iii) of this section) that has not been previously includible in the employee's gross income, to the extent that such a distribution is permitted under the trust (or the plan of which the trust is a part);

(ii) Second, from that portion of the employee's interest in the trust attributable to contributions made by the employer on or before August 1, 1969 (or contributions referred to in paragraph (d)(1) (ii) or (iii) of this section);

(iii) Third, from the remaining portion of the employee's interest in the trust attributable to contributions made by the employer.

If the employee has made contributions to the trust, amounts attributable thereto shall be treated as distributed prior to any amounts attributable to the employer's contributions, to the extent provided by the trust (or the plan of which the trust is a part).

However, the portion of such amounts attributable to income earned on the employee's contributions made after August 1, 1969, shall be treated as distributed prior to any return of such contributions.

(d) *Taxation by reason of employer contributions made on or before August 1, 1969.* (1) Except as provided in section 402(d) (relating to taxable years beginning before January 1, 1977), any contribution to a trust made by an employer on behalf of an employee—

(i) On or before August 1, 1969, or

(ii) After such date, pursuant to a binding contract (as defined in § 1.83-3(b)(2)) entered into before April 22, 1969, or

(iii) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969, and under which the obligation of the employer on such date was essentially the same as under a binding written contract, during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a) shall be included in income of the employee for his taxable year during which the contribution is made, if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made, even though his interest becomes nonforfeitable later the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2)(i) An employee's beneficial interest in the contribution is nonforfeitable, within the meaning of sections 402(b), 403(c), and 404(a)(5) prior to the amendments made thereto by the Tax Reform Act of 1969 and section 403(b), at the time the contribution is made if there is no contingency under the plan that may cause the employee to lose his rights in the contribution. Similarly, an employee's rights under an annuity contract purchased for him by his employer change from forfeitable to nonforfeitable rights within the meaning of section 403(d) prior to the repeal thereof by the Tax Reform Act of 1969 at that time when, for the first